

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1978

No. 78-606

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY,
Petitioner,

vs.

THE PUBLIC UTILITIES COMMISSION OF THE
STATE OF CALIFORNIA, and ROBERT BATINOVICH,
VERNON L. STURGEON, RICHARD D. GRAVELLE,
CLAIRE T. DEDRICK, and WILLIAM SYMONS, JR.,
the members of said Public Utilities Commission, et al.,
Respondents.

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GENERAL TELEPHONE COMPANY OF CALIFORNIA,
Petitioner,

vs.

THE PUBLIC UTILITIES COMMISSION OF
THE STATE OF CALIFORNIA, ET AL.,
Respondents.

On Petitions for Writs of Certiorari to the
Supreme Court of the State of California

BRIEF FOR RESPONDENT PUBLIC UTILITIES COMMISSION IN OPPOSITION

JANICE E. KERR

HECTOR ANNINOS

TIMOTHY TREACY

WALTER H. KESSENICK, JR.

5066 State Building
San Francisco, Calif. 94102
Telephone (415) 557-0336

Attorneys for Respondent

*The Public Utilities Commission
of the State of California*

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BRIEF FOR RESPONDENT

PUBLIC UTILITIES COMMISSION IN OPPOSITION

OPINIONS BELOW

The opinions below are correctly set forth in the
Petitions.

JURISDICTION

Jurisdiction is alleged under provisions of Title 28,
Section 1257(3). As hereinafter shown, the respondent

Public Utilities Commission challenges jurisdiction on the grounds that the petitions are inadequate to show how and in what manner federal questions were properly and timely raised in the State Supreme Court.

QUESTION PRESENTED

Whether an order of the California Public Utilities Commission (Commission) that The Pacific Telephone Company (Pacific) and General Telephone Company of California (General) refund money to their ratepayers and reduce their current rates to reflect a portion of their reduced federal income tax expenses violates the equal protection clause of the 14th Amendment.

As explained in more detail hereinafter, the additional question of violation of the Supremacy Clause of Art. VI, raised by Pacific, is not properly before this Court.

STATUTES AND REGULATIONS INVOLVED

The pertinent provision of the Internal Revenue Code (IRC) of 1954 as amended, 26 U.S.C. §§ 167(e) and 46(f) are reprinted in Appendix C of the Petitioners' Joint Appendix (Pet. App.) as are the applicable Treasury Regulations, 26 C.F.R. §§ 1.167(1)—1(h)(1) and (6).

STATEMENT

This litigation concerns a decision of the Commission, Decision No. 87838, issued September 13, 1977. In that decision the Commission ordered Pacific and General to reduce rates and make refunds of money previously collected subject to refund. The basis for these reductions and refunds was a determination that Pacific's and General's reasonable expenses for federal income tax

could lawfully be computed by making an averaged annual adjustment (AAA) to reflect changes in the deferred tax reserves resulting from Pacific's and General's use of accelerated depreciation to figure depreciation expense and an annual adjustment (AA) to reflect the effect of their use of option 2 (ratable flow through) to figure Investment Tax Credit (ITC).¹

In two previous decisions, the Commission had concluded that it had no lawful alternative to setting Pacific's and General's rates on a normalized basis, i.e. to reflect income tax expense as though it had been incurred on a straight line depreciation basis rather than on an accelerated depreciation basis.

Both of these decisions were subsequently annulled by the California Supreme Court on grounds that the Commission had not fully considered its lawful ratemaking alternatives.²

Among those alternatives, the California Court went on to state, were an adjustment to rate of return or an end-of-year adjustment to rate base. The Court also held that imputed flow-through could be considered and would not violate Pacific's 14th Amendment guarantee of due process in view of the telephone utilities' past imprudence in not taking advantage of tax benefits when they were

¹The AAA and AA methods are fully described and explained in Decision No. 87838, Appendix B to Pet. App, at pages 25A-31A and thus need not be repeated in full here.

²*City and County of San Francisco v. Public Utilities Commission*, 1971, 6 C.3d 119; *City of Los Angeles v. Public Utilities Commission*, 1975, 15 C.3d 680 (Appendix A of Respondents' Joint Appendix [Resp. App.]).

available to them.³ In Decision No. 87838 the Commission has adopted an equitable compromise, fair to both the current taxpayer and the utility.

In Decision No. 87838 the Commission concluded that use of the AAA and AA methods was not precluded by law and would not cause Pacific and General to lose eligibility for the tax benefits at question.

Pacific and General petitioned the Commission for rehearing of Decision No. 87838, which petitions were denied. Thereafter they filed separate petitions in the California Supreme Court for writ of review.⁴ Those petitions were separately denied, without opinion, by that court on July 13, 1978. (Appendix A of Pet. App.).

REASONS FOR DENYING THE WRIT

I

THE PETITIONS ARE INADEQUATE TO RAISE A FEDERAL QUESTION BECAUSE THEY LACK SPECIFICITY.

Both petitions seek review of a judgment of the California Supreme Court. Rule 23.1(f) of this Court's rules provides in pertinent part:

". . . If review of the judgment of a state court is sought, the statement of the case shall also specify the stage in the proceedings in the court of first instance and in the appellate court, at which, and

³*City and County of San Francisco v. Public Utilities Commission*, supra at p. 129.

⁴S.F. No. 23743, *General Tele. of Calif., v. Public Util. Comm.*; S.F. No. 23746, *The Pacific Tele. & Tele. Co. v. Public Util. Comm.*

the manner in which, the federal questions sought to be reviewed were raised; the method of raising them (e.g., by a pleading, by request to charge and exceptions, by assignment of error); and the way in which they were passed upon by the court; such pertinent quotations of specific portions of the record, or summary thereof, with specific reference to the places in the record where the matter appears (e.g., ruling on exception, portion of the court's charge and exception thereto, assignment of errors) as will show that the federal question was timely and properly raised so as to give this court jurisdiction to review the judgment on writ of certiorari."

General's petition is totally inadequate to show when and how it raised the federal question before the California Supreme Court. General merely states that, in its petition to that court, it asserted, "...that the order threatened to deprive General of its property without due process of law . . ." (General's petition at page 16). Such a statement fails to provide the specific information, references and quotations required by Rule 23.1(f).

Pacific's petition, in a footnote on page 11 thereof, asserts that it raised federal questions before the Commission and, in another footnote on page 12 thereof, that it raised constitutional questions before the California Court. As shown in more detail hereafter, the latter footnote is at least inaccurate and at worst misleading. However for purposes of this argument it is sufficient to note that Pacific failed to provide:

". . . such pertinent quotations of specific portions of the record or summary thereof . . . as will show that the federal question was timely and properly raised . . ." (Rule 23.1(f)).

Therefore Pacific's petition is inadequate to show that jurisdiction has been given this Court to review the judgment on writ of certiorari.

II

PACIFIC'S ALLEGATION THAT THE CALIFORNIA DECISION IS AT ODDS WITH THE SUPREMACY CLAUSE OF ARTICLE VI OF THE U.S. CONSTITUTION IS NOT PROPERLY RAISED BECAUSE PACIFIC FAILED TO RAISE THAT ALLEGATION IN THE CALIFORNIA COURT IN A TIMELY AND PROPER MANNER.

Title 28, Section 1257(3) requires by its terms that the federal question be "... drawn in question." This requirement speaks to jurisdiction and may be fulfilled only by a showing that the federal question was raised below in a timely and proper manner, *Walters v. City of St. Louis, Mo.*, 1954, 347 U.S. 231. The proper manner of raising the federal question is dependent upon state practice; *Beck v. Washington*, 1962, 369 U.S. 541, 549.

Pacific failed to raise this question in its petition to the California Supreme Court for a writ of review of the Commission's Decision. That petition, which under California rules constitutes Pacific's brief on the merits, contains absolutely no reference to Article VI nor was Article VI included in its Table of Authorities in said petition (Resp. App. C at page 73 RA). Pacific's first mention of Article VI of the California Court was in its reply brief to the Commission's answer.⁵ That was not a timely nor

⁵Pacific's footnote No. 15 on page 12 of its petition is so loosely worded that it is misleading. Pacific seems to be asserting that it raised both the 14th amendment and the Article VI questions in its petition for writ of review to the California Supreme Court: In point of fact, however, it raised only the 14th amendment question.

a proper manner of raising the question under California law, *Radinsky v. Thomas (T.W.) Inc.*, 1968, 264 Cal. App.2d 75.

Pacific can take no comfort from the fact that General raised the question in its own petition to the California Court. The two petitions were separately filed and briefed by the petitioners and were denied in separate orders by the California Court, (Appendix A, pages 1A and 2A of Pet. App).

General, which could now raise the question, has not done so.

In any event, the Commission has not violated federal law in its decision nor is its decision in conflict with such law. IRC Sections 46 and 167 are directed to the taxpayer, not to the Commission.

In 1969, legislation was proposed to restrict ratemaking actions of federal and state regulatory agencies. However such restrictions were specifically not enacted in view of the constitutional problems as expressed by Chairman Mills during the hearings.

"I understand your legal point, that we have no right to tell you how to fix rates on intrastate matters in the State of California. I agree with you, that would be an invasion of your right." (Hearings on HR6659, House Committee on Ways and Means, p. 3887, 91st Congress (1969).)

There being no act by the Commission in violation of a federal law nor against the intent of Congress, no violation of the Supremacy Clause is shown.

III

THE JUDGMENT BELOW IS CLEARLY CORRECT.

The AAA and AA methods at question are a lawful exercise of the Commission's jurisdiction and conform to the applicable tax laws and regulations.

A. Accelerated Depreciation

Decision No. 87838 concludes that Pacific and General must use "normalized" accounting procedures to be eligible to use accelerated depreciation and that the AAA method conforms to the strictures on such procedures in IRC Section 167.1 and in Treasury Regulation 1.167(e)-(1)(h)(6). (see Pet. App. at pages 25A-28A). Unable to show that use of the AAA method is prohibited by the express language of those sections, Pacific and General urge that violation nevertheless results because the effect is to reduce the rate base by more than the amount of the addition to the tax reserve inasmuch as the tax expense and the growth of deferred tax reserve are not estimated in the same manner. But the law and the regulations do not specify the manner of estimating the tax expense and tax reserve, merely that they be estimated for the same time period. It is uncontested that the AAA method does exactly that.

Furthermore, the AAA method recognizes that the growth of the deferred tax reserve varies out of all relationship to the changes in other elements of Pacific's and General's expenses and revenues. It therefore holds those other elements constant when estimating a future change in tax expense and deferred tax reserves. As Decision No. 87838 explains (Pet. App. B at pages 27A, 28A) assuming constants is a common and lawful aspect of ratemaking.

B. ITC

As discussed in Decision No. 87838 (Pet. App. at pages 28A-31A), the AA method sets rates for an estimated test year by deducting the rateable amount of the ITC for that year from tax expense and makes annual adjustments thereafter to reflect subsequent changes in such expenses. The IRC does not impose any specific method on the Commission for determining the correct ratable amount to be deducted. Nevertheless, as with accelerated depreciation, Pacific and General allege that loss of eligibility will occur because of the possibility that a use of the AA method may result in a greater than ratable amount being deducted in years after the test year. The Commission does not concur. An annual adjustment clearly meets the requirements of the IRC Section 46(f)(2). However, as with accelerated depreciation, only the future will disclose whether or not a loss of eligibility will result or what tax deficiency, if any, will be assessed by the IRS or upheld by a competent court.

IV

THERE IS NO IMPORTANT QUESTION OF FEDERAL LAW.

Contrary to assertions by Pacific and General that the question raised has broad, national significance, the fact is that the ratemaking decision at issue applies only to them and was developed specifically to deal with the problems arising from their past refusal to adopt accelerated depreciation with flow-through between 1954 and 1970 (a refusal the Commission and the California Court found to be imprudent)⁶ and their subsequent decisions to adopt accelerated depreciation with normalization under provisions of the Tax Reform Act of 1969.

⁶Decision No. 87838, p. 45A of Pet App.; *City and County of San Francisco v. Public Utilities Commission*, 1971, 6 C.3d 119, 129.

The Petitioners' predictions of a bandwagon effect are mere supposition. The Commission's ratemaking methods at issue here have not been utilized by any other regulatory agency. In fact, a review of Decision No. 87838 and the decisions of the California Supreme Court which preceded it⁷ shows clearly that Decision No. 87838 has a unique history, not likely to be duplicated.

Furthermore, there is no reason to believe that a denial of a writ of certiorari would encourage other agencies or courts to follow the California example. Such a denial is not a judgment on the merits nor a precedent for like action in a similar case, *Wade v. Mayo*, 1948, 334 U.S. 672, 680.

V

THE JUDGMENT BELOW DOES NOT VIOLATE THE DUE PROCESS GUARANTEES OF THE FOURTEENTH AMENDMENT.

Pacific alleges that the judgement below is in conflict with the holding in *West Ohio Gas Co. (No. 2) v. Public Utilities Commission*, 1935, 294 U.S. 79, in which a rate reduction order was held to be constitutionally defective because the regulatory agency relied exclusively on 1929 data in setting rates for 1933, ignoring available revenue and expense data for 1930 and 1931.

A fair reading of Decision No. 87838 shows that the Commission did not ignore available data (see Pet. App. at pages 35A, 36A). Moreover, the rates in question have been specifically subject to refund. The California Supreme Court annulled and remanded the Commission's earlier de-

⁷*City and County of San Francisco v. Public Utilities Commission*, 1971, 6 C.3d 119; *City of Los Angeles v. Public Utilities Commission*, 1975, 15 C.3d 680, (Appendix A of Resp. App.).

cisions specifically to consider these tax questions. No such facts were present in the *West Ohio* case nor was the defendant there dealing with a future test year as was the Commission. The *West Ohio* case is clearly irrelevant.

Pacific and General further allege, but cannot show, that the judgment below is constitutionally defective because it will result in loss of their eligibility for tax reductions both under Section 167(e) of the Internal Revenue Code of 1954 as amended (accelerated depreciation) and Section 46f thereof (ITC). Such a loss of eligibility, it is alleged, will be retroactive for the years not yet audited by the Internal Revenue Service (IRS) as well as prospective and will result in higher tax expenses than those provided for in rates. This in turn, it is alleged, will be destructive to the petitioner's financial integrity.

Pacific's allegation that its financial integrity will be destroyed if the judgment below is allowed to stand is simply a continuation of scare tactics which it has repeatedly used before this Court and the California Court. Pacific has always predicted that financial disaster would result if its own proposals for dealing with tax expenses were not adopted. The simple fact is that such disasters do not occur.

Insofar as such predictions relate to refunds and rate reductions, as far back as 1972 Pacific argued to this Court that a decision of the California Supreme Court should be stayed because, "... The amount involved is so large as to have a serious adverse effect on the petitioner's financial condition and its ability to serve the public."⁸

⁸A69, *Pacific Telephone Co. v. City of Los Angeles*, denied July 28, 1972 by Justices White and Renquist.

On still another occasion Pacific told the Commission that adopting flow through would result in "... degradation of service and possible financial collapse," and that the "... utilities would go bankrupt."⁹

However Pacific changes this scenario at will. For example, when a ratepayer petitioned in the California Supreme Court for a stay of a rate increase pending resolution of these very income tax questions, Pacific opposed the stay and specifically represented to the Court that, should the tax questions be resolved adversely to Pacific, it would be able to make refunds. "Pacific is financially capable of any such refunds," the Court was told. Pacific further cited its experience in being able to make refunds in the past.¹⁰

Insofar as Pacific's predictions relate to a loss of eligibility for the tax benefits at issue, the fact is that no such loss of eligibility has occurred. No tax deficiency has been assessed. The (IRS) letters (Pet. App. at page 95A et seq), relied on by Pacific and General, are neither determinative of eligibility nor binding on either the IRS or the taxpayer.¹¹

Furthermore, the IRS itself is not proceeding in accordance with those letters. Pacific's petition to this Court includes, on page 21, an estimate of potential tax liability beginning with the year 1974. This is most significant. Pacific told the California Supreme Court that it was

⁹*City of Los Angeles v. Public Utilities Commission*, 15 C.3d, 1975, 680, 688 (Sesp. App. A at page 26 RA).

¹⁰*Bennett, et al. v. Public Utilities Commission*, S.F. No. 23180.

¹¹Pacific, as a subsidiary of The American Telephone & Telegraph Co. (AT&T) files a consolidated tax return. No allegation has been made that AT&T would lose eligibility as a result of the judgment below. The same facts obtain as to General and General Telephone and Electronics (GTE).

faced with a potential tax liability beginning with the year 1970, not 1974, even though Pacific knew at that time that the IRS had closed the books on 1970, finding no tax deficiency.

Now Pacific begins its estimate with 1974, not bothering to explain that the IRS has recently completed its tax audit for the additional years of 1971, 1972 and 1973, again with no assessment of deficiency.

It is especially significant that the last date upon which the IRS could have assessed a deficiency for those years or extended the period of limitation was June 30, 1978, three weeks after the IRS letters regarding accelerated depreciation were issued, and that the IRS did not extend that period.

The above instance is merely one example wherein the federal government's position on these matters of eligibility for income tax benefits has been confusing and contradictory. This has caused problems for the Commission in carrying out its mandated regulatory duties and subjected the parties to expensive and burdensome litigation.

Additional contradictions include:

1. A letter dated January 11, 1977 from Mr. Geoffrey Taylor of the IRS to the New Mexico Public Service Commission (Resp. App. D at page 78 RA et seq.) in which Mr. Taylor concluded that a utility would lose eligibility for Job Development Investment Credit (JDIC) unless, "... in determining the overall cost of capital of a utility for rate making purposes, deferred investment tax credits are properly to be included and assigned a rate not less than that considered applicable to common equity."

2. The IRS ignored this conclusion during its 1971-1973 audit and did not challenge Pacific's treatment of JDIC even though that treatment did not conform to Mr. Taylor's letter.

3. The Federal Energy Regulatory Commission, in *Carolina Power and Light*, Docket No. ER76-495 (Phase II Opinion 19, Aug. 12, 1978, printed in 15 Federal Power Service 5-619, 624, concluded that the above quoted statements in Mr. Taylor's letter "... do not represent a correct interpretation of the requirements of Section 46f."

4. The General Services Administration and the Secretary of Defense, on behalf of the consumer interests of all the executive agencies of the United States, filed a brief with the Commission during the proceedings which culminated in Decision No. 87838. In that brief the federal government's position was that the Commission could adopt a "pro-forma normalization" of Pacific's deferred tax reserves because such a method would conform to the applicable provisions of the IRC. Pro-forma normalization was discussed in Decision No. 87838 (Pet. App. at page 17A). That position is in direct opposition to the conclusions contained in two IRS letters, by the same Mr. Taylor, which Pacific and General rely on for their allegations that they will lose their eligibility to use accelerated depreciation.

The Commission is confident that the judgment below is correct. However, the above listed confusions and uncertainties cry out for an early resolution. It would benefit

all parties as well as Pacific's and General's ratepayers if this Court would hear and decide the issue of tax eligibility in favor of the Commission now.

CONCLUSION

For the foregoing reasons it is respectfully submitted that these petitions for a writ of certiorari should be denied.

November 13, 1978.

Respectfully submitted,

JANICE E. KERR

HECTOR ANNINOS

TIMOTHY TREACY

WALTER H. KESSENICK, JR.

Attorneys for Respondent

*The Public Utilities Commission
of the State of California*